

Franchise Tax Board's Instructions for FTB Notice 2007-1, California's Compliance Resolution Program for Employers Participating, or Intending to Participate, in the IRS Compliance Resolution Program Regarding Internal Revenue Code Section 409A

Introduction

On February 8, 2007, the Internal Revenue Service (IRS) issued IRS Announcement 2007-18, available online at <http://www.irs.gov/pub/irs-drop/a-07-18.pdf>, announcing a compliance resolution program (the IRS Program) that permits employers to pay the additional taxes arising under Internal Revenue Code (IRC) § 409A due to the exercise of certain discounted stock options and stock appreciation rights (collectively referred to as stock rights) in 2006. The IRS Program requires employers to notify the IRS of the employer's intent to participate in the IRS Program by February 28, 2007.

On February 23, 2007, the Franchise Tax Board issued FTB Notice 2007-1, available online at http://www.ftb.ca.gov/law/notices/2007/2007_1.pdf, which announced that employers participating, or intending to participate, in the IRS Program may also participate in the corresponding California Compliance Resolution Program (California Program). As described in the Notice and pursuant to Revenue and Taxation Code (R&TC) § 17501 and § 24601, IRC § 409A is applicable for California purposes. The California Program will parallel the IRS Program.

The California Program procedures closely parallel the IRS Program procedures. However, the California Program's deadline for an employer to file its notice of intent to participate is March 15, 2007. In calculating the interest tax component of the § 409A taxes, the California Program will use California's highest marginal tax rate in effect for 2005 (9.3%) and California's underpayment rate plus one percent. Employer payments submitted pursuant to the California Program must be made by check; payments by Electronic Funds Transfer (EFT) will not be accepted.

Like the IRS Program, the California Program provides a means to minimize the burdens of compliance on employees who are not corporate insiders, while ensuring all applicable taxes are paid. As described in more detail below, the California Program:

- Applies only to discounted stock rights exercised during 2006.
- Applies only to employees and former employees who are not subject to the disclosure requirements under section 16(a) of the Securities Exchange Act of 1934 (a non-insider), and were not subject to such requirements at the date of grant of the stock right.
- Requires full payment by the employer of the applicable § 409A taxes arising from the exercise of the stock right.
- Provides relief for the employees from the requirement to pay the § 409A taxes.
- Does not affect an employer's obligation to report the compensation income and wages arising from the exercise of the stock right on the Form W-2, to apply the appropriate employment taxes, and does not affect an employee's obligation

to report such compensation income on the Form 540 and pay the applicable income tax (other than the additional § 409A taxes).

- Requires treatment of the employer's payment of the employee's § 409A taxes as an additional payment of compensation to the employee in the employee's taxable year in which the payment is made.
- Requires notice to employees and to the FTB of the employer's participation in the California Program.

Employers that wish to participate in the California Program must notify the FTB no later than March 15, 2007, of their intent to participate, and must notify affected employees within 15 days of providing the notification to the FTB.

Section 1. Background

California conformed to IRC § 409A at the time it was enacted by application of R&TC § 17501 and § 24601. For background information regarding § 409A, see IRS Announcement 2007-18, available online at <http://www.irs.gov/pub/irs-drop/a-07-18.pdf>.

If steps are not taken before the exercise of a stock right to avoid a violation of § 409A, the exercise of a discounted stock right during 2006, where the term of the stock right otherwise extended beyond 2006, generally is treated as an impermissible payment of nonqualified deferred compensation under § 409A. This impermissible payment generally triggers adverse Federal and California income tax consequences under § 409A for the service provider. The resulting tax consequences include immediate income inclusion; an additional 20% income tax (in accordance with § 409A(a)(1)(B)(i)(II)) on the amounts required to be so included (the 20% tax); and a second additional tax (in accordance with § 409A(a)(1)(B)(ii)) equal to the interest on unpaid California taxes from the year of initial deferral (or if later, the first year the deferred amount was not subject to a substantial risk of forfeiture), calculated at the California underpayment rate plus 1% (the interest tax).

IRS Announcement 2007-18 also addresses plan aggregation rules and the effect of substituting a stock right that is not subject to § 409A in the place of a stock right that is subject to § 409A. The discussion in IRS Announcement 2007-18, available online at <http://www.irs.gov/pub/irs-drop/a-07-18.pdf>, would also be applicable for California purposes.

Section 2. Scope of Program

The California Program addresses only the additional § 409A taxes for the employee's 2006 tax year resulting from the exercise of an applicable stock right (discussed below), and the information reporting requirements related to such § 409A taxes. The California Program does not address other consequences that may arise from the grant or exercise of a stock right with an exercise price less than the fair market value of the underlying stock on the date of grant. Accordingly, the California Program does not address the employer's obligation to report the compensation income arising from the exercise of the stock right on the 2006 Form W-2, and to apply the appropriate

employment taxes to the payment of wages. The California Program also does not address the employee's obligation to report such compensation income on the Form 540 and pay the applicable income tax (other than any additional § 409A taxes). The California Program also does not address the non-§ 409A tax consequences, including employment tax and information reporting consequences, that may arise from a failure of a purported incentive stock option to meet the requirements of § 422, or the application of § 162(m) to an employer's otherwise available deduction for compensation expense with respect to the exercise of a stock right.

Section 3. Eligibility Requirements

The California Program is available to an employer that granted applicable stock rights that were subject to the requirements of § 409A because the exercise price was below the fair market value of the underlying stock on the date of grant, where such stock rights were exercised during the employee's 2006 tax year. For this purpose, an applicable stock right means any stock right granted in connection with the performance of services by an employee other than a stock right granted to an employee who is subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934 as of the date the employer provides a notice of intent to participate in the program under section 4.A or who was subject to such disclosure requirements on the date of grant of such stock right.

Section 4. Terms of Participation in the Program

If an employer complies with all of the requirements in this section 4 with respect to an employee, the employer and the employee will be eligible for the relief set forth in section 5 of these instructions:

A. Notice to the FTB of Intent to Participate

An employer must submit to the FTB by March 15, 2007, a notice of the employer's intent to participate in the California Program. The notice of intent to participate must state, under penalties of perjury, the following:

[Insert name of the employer and taxpayer identification number] hereby provides notice to the FTB of its intent to participate in the California Program described in FTB Notice 2007-1. [Insert name] is the person for the FTB to contact regarding the participation of [Insert name of the employer] in the California Program, and may be contacted at [Insert address and phone number]. *Choose either sentence A or sentence B.* *Sentence A.* [Insert name of the employer] hereby certifies that [Insert name of the employer] is not under examination by the FTB. *Sentence B.* [Insert name of the employer] hereby certifies that [Insert name of the employer] is under examination by the FTB and is providing a copy of this notice of intent to participate in the California Program to the examining FTB employee.

An employer must also submit an FTB Form 3520 Power of Attorney Declaration or an IRS Form 2848, Power of Attorney and Declaration of Representative modified to include FTB related information as described at <http://www.ftb.ca.gov/law/Poa/forms.html>, as appropriate. For information regarding the submission of this notice, see section 6 of these instructions.

B. Notices to Affected Employees and FTB

i. Notice to Affected Employees of Intent to Participate

No later than 15 days after the employer submits the notice of intent to participate described in section 4.A of these instructions, an employer must provide a notice to all employees that the employer reasonably anticipates may be affected by the employer's participation in the California Program. Such notice must provide the following information:

- (i) the employer has notified the FTB of the employer's intent to participate in the California Program (the California Program must be specifically referred to in the notice to employees as the program set forth in FTB Notice 2007-1, California's Compliance Resolution Program for Employers Participating, or Intending to Participate, in the IRS Compliance Resolution Program Regarding Internal Revenue Code Section 409A);
- (ii) the employer intends to provide further notice to the employee on or before July 15, 2007 certifying that the employer has made a further submission to the FTB that to the best of its information, knowledge, and belief, satisfies the requirements of these instructions, or certifying that the employer has not made such a further submission;
- (iii) the employer's participation in the California Program may affect the employee's California income tax obligations solely with respect to the additional taxes imposed under IRC § 409A and R&TC § 17501 due to the exercise of discounted stock options or stock appreciation rights, but does not affect the employee's obligation to report on Form 540 the compensation income arising from the exercise that is shown on the Form W-2 (or W-2c, if applicable) provided to the employee or to pay the applicable California taxes (other than the additional § 409A taxes).

To the extent a notice of intent to participate in the IRS Program is sent to employees and such notice satisfies the requirements for a notice specified in these instructions for the California Program, FTB will accept such notice for the California Program.

The notice to affected employees may provide additional information that is not inconsistent with the required information. The notice must be provided directly to the individual employee, but may be provided electronically. If an employer provides such notices to employees that the employer reasonably anticipates may be affected by the employer's participation in the California Program, and subsequently determines that an exercise of a stock right by an additional employee is eligible to be included in this California Program, the employer may include such additional employee and exercise in a further submission without providing the notices required by this Section 4.B, provided

all other requirements of these instructions are met with respect to such additional employee.

ii. Second Notice to FTB

No later than 15 days after the employer submits the notice of intent to participate described in section 4.A of these instructions, the employer must provide a notice to the FTB stating the number of employees to whom the notices required by section 4.B.i of these instructions were provided.

C. Employer's Further Submission of Information and Payment to the FTB

An employer must make a further submission of information and payment (a further submission) to the FTB by June 30, 2007, meeting all of the requirements of this section 4.C.

i. Information

An employer must include in the further submission to the FTB the following information, signed under penalties of perjury:

- a. The employer's name and taxpayer identification number.
- b. A list of employees for whom the employer is remitting the § 409A taxes due (the 20% tax and the interest tax) under section 4.C.ii below, including each such employee's taxpayer identification number.
- c. For each identified employee, an identification of each stock right exercise resulting in the § 409A taxes, including information that specifically identifies the specific stock right that was exercised, the date of exercise, the exercise price, the fair market value of the underlying shares on the date of exercise, and the number of shares purchased or, in the case of a stock appreciation right, the number of shares used to calculate the payment made.
- d. For each identified stock right exercise for each identified employee, the amount of § 409A taxes remitted, including the manner in which such § 409A taxes were calculated.

ii. Remittance of All § 409A Taxes Due

a. Remittance of Taxes

With respect to an exercise of a stock right subject to § 409A by an employee during 2006, the employer must remit to the FTB by June 30, 2007, an amount equal to the full amount of the additional tax liability of the employee under § 409A that results from such exercise. Such additional tax consists of the 20% tax and the interest tax described below. For purposes of determining the § 409A taxes, the amount of income

includible under § 409A must be determined in accordance with applicable guidance under § 409A. With respect to such exercise of a stock right, an employer is treated as having remitted an amount equal to the full amount of the additional tax liability if the employer remits substantially all of the additional tax liability based upon a reasonable, good faith interpretation of the applicable guidance. Where it is determined that an employer has failed to submit substantially all of the additional tax liability that results from the exercise of a stock right subject to § 409A during 2006 based upon a reasonable, good faith interpretation of the applicable guidance, neither the employer nor the employee is entitled to any relief under these instructions with respect to the § 409A taxes resulting from the exercise of such stock right.

For the California Program, all payments must be made by check and submitted by mail, private carrier, or overnight delivery service. All checks must be payable to "Franchise Tax Board" and contain a notation on the check indicating the payment is for "CA 409A Compliance Program."

Electronic Funds Transfer (EFT) is not an accepted payment method for participation in the California Program.

b. Calculation of the 20% tax

For purposes of the California Program, the amount of the 20% tax equals 20% of the excess of the fair market value of the stock on the date of exercise over the sum of the exercise price paid by the employee and any other amount paid by the employee for the stock right. See IRS Notice 2006-100.

c. Calculation of the Interest Tax

For purposes of the California Program, the amount of the interest tax equals the amount of interest at the California underpayment rate plus 1% on the underpayment of California income tax that would have occurred had the portion of the amount deferred under the stock right as of December 31, 2005, that was not subject to a substantial risk of forfeiture (as defined for purposes of § 409A) as of December 31, 2005, been includible in gross income as of December 31, 2005. For this purpose, the amount deferred under the stock right as of December 31, 2005, equals the excess of the fair market value of the underlying stock on December 31, 2005, over the sum of the exercise price and any other amount paid by the employee for the stock right. For purposes of the California Program, employers must calculate the underpayment based on the highest marginal California income tax rate in effect for 2005 (9.3%). For purposes of determining the applicable interest, the underpayment is treated as due on April 17, 2006, and the interest runs from that date through the earlier of April 17, 2007, or the date the further submission is sent to the FTB with payment.

d. Additional Amount Due for Taxes Remitted After April 17, 2007

For payments sent to the FTB after April 17, 2007, the amount required to be submitted is increased by an amount equal to the California underpayment interest rate applied to

the amount that would otherwise be due on April 17, 2007, through the date the further submission (with payment) is sent to the FTB.

iii. Section 409A Tax Payments Constitute Compensation to the Employee

The payment of the § 409A taxes due as part of the California Program constitutes additional compensation income to the employee for the employee's taxable year in which such payment is made. Accordingly, the employer must represent under penalties of perjury that the employer is treating such payment as additional compensation to the employee for the taxable year of such employee in which such payment is made, in accordance with this section iii. With respect to any employee for whom a payment of § 409A taxes has been made as part of the further submission, no relief shall be provided under these instructions with respect to the exercise of a stock right by such employee during 2006 if it is determined that the employer has failed to treat such payments as additional compensation for the taxable year of such employee in which such payment is made, in accordance with this section iii.

For California tax purposes, payments on behalf of an employee or former employee to cover federal and California § 409A taxes are wages and subject to the applicable California income tax and employment tax requirements, including but not limited to, Unemployment Insurance, Employment Training Tax, and State Disability Insurance. These payments are subject to personal income tax withholding and should be included on Form W-2. Additionally, such payments are reportable as wages, and should be reported by the employee as taxable income on his or her personal income tax return for the year in which the payments are received.

iv. Further Representations by the Employer

The further submission must include the following representations by the employer, signed under penalties of perjury:

- a. In accordance with section 4.B.i of these instructions, the employer provided the notices of the employer's intent to participate in the California Program to all employees the employer reasonably anticipated would be affected by the employer's participation in the program by no later than 15 days after the employer submitted its notice of intent to participate in the California Program to the FTB.
- b. With respect to any employee for which a payment of § 409A taxes has been made as part of the further submission, the employer has made reasonable, good faith efforts to identify all exercises of a stock right by such employee during 2006 that resulted in the inclusion of income under § 409A, applying a reasonable, good faith interpretation of the applicable guidance under § 409A, has listed all such identified exercises of a stock right in its further submission, and has accurately calculated and paid the § 409A taxes resulting from such identified exercises of a stock right in accordance with these instructions.

c. The employer will, upon a written request from an affected employee, disclose to the employee any portion of such information that is relevant to the employee's 2006 California income tax return, including information the employee reasonably needs to respond to an information request from the FTB, an examination, or tax litigation involving issues related to the exercise of a stock right and the application of § 409A.

D. Notice to Affected Employees of the Employer's Further Submission

An employer must provide a notice to all employees to whom a notice was provided pursuant to section 4.B.i, and any additional employees that are listed in the employer's further submission to the FTB, by no later than July 15, 2007, certifying the following:

(i) the employer has made a further submission under the California Program, that is specifically referenced as the program provided under FTB Notice 2007-1, California's Compliance Resolution Program for Employers Participating, or Intending to Participate, in the IRS Compliance Resolution Program Regarding Internal Revenue Code Section 409A, that to the best of the employer's information, knowledge and belief, satisfies the requirements of FTB Notice 2007-1, and that such further submission (a) includes the employee and makes payment of such employee's § 409A taxes addressed by FTB Notice 2007-1 or (b) does not include the employee because the employer has concluded that the employee does not owe any § 409A taxes addressed by FTB Notice 2007-1, or

(ii) the employer has failed to make a further submission under the California Program, that is specifically referenced as the program provided under FTB Notice 2007-1, California's Compliance Resolution Program for Employers Participating, or Intending to Participate, in the IRS Compliance Resolution Program Regarding Internal Revenue Code Section 409A, and the employee is therefore liable for any applicable § 409A taxes.

To the extent a notice to affected employees of the employer's further submission to the IRS Program is sent to employees and such notice satisfies the requirements for a notice specified in these instructions for the California Program, FTB will accept such notice for the California Program.

The notice to affected employees may provide additional information that is not inconsistent with the required information. The notice must be provided directly to the individual employee, but may be provided electronically.

Section 5. Scope of Relief

A. Employer's Information Reporting Requirements

Consistent with IRS Announcement 2007-18, section 5.A., available online at <http://www.irs.gov/pub/irs-drop/a-07-18.pdf>, if an employer complies fully with the provisions of section 4 of these instructions, with respect to an exercise of a stock right by an employee, for purposes of an employer's information reporting requirements

under California law the employer will not be subject to any penalties pursuant to R&TC § 19183.

Nothing in the California Program relieves the employer of any information reporting requirements with respect to an employee or an exercise of a stock right that was not identified in the employer's further submission. Nothing in these instructions, FTB Notice 2007-1, or the California Program affects the employer's obligation to report the amount that would be required, without regard to § 409A, to be included in income and wages due to the exercise of a stock right, and to withhold and pay the applicable employment taxes, or the employee's obligations to include such amounts in income and pay California taxes on them (other than § 409A taxes).

B. Employee's § 409A Taxes

If an employer complies fully with the provisions of section 4 of these instructions with respect to amounts includible in income under § 409A due to the exercise of an applicable stock right by an employee during 2006, the employee will not be required to pay the § 409A taxes on the applicable California income tax return for the 2006 tax year with respect to such amounts includible in income under § 409A. Nothing in the California Program relieves the employee of any § 409A taxes with respect to an exercise of a stock right that was not identified in the employer's further submission, or relieves the employee or employer of any other tax, including California income tax and employment taxes that would otherwise arise from the exercise of the stock right. In addition, nothing in the California Program addresses or relieves the employee of any § 409A taxes due to participation in a nonqualified deferred compensation plan, other than the exercise of an applicable stock right in 2006.

An employee who received a notice of application under section 4.B.i of these instructions, and who files a return before finding out that, due to a failure by the employer to comply with the requirements for relief set forth in these instructions, the employee is not relieved of the duty to report and pay § 409A taxes, will be treated as having had reasonable cause and as having acted in good faith with respect to the portion of any underpayment that is due to the employee's failure to timely pay § 409A taxes arising from the exercise of an applicable stock right in 2006, and will not be subject to penalties for the 2006 tax year pursuant to R&TC § 19136, for any estimated tax underpayment attributable to such failure. An employee who received a notice of application under section 4.B.i of these instructions and files a timely income tax return by the filing extension deadline after learning that he or she is not relieved of the duty to report and pay § 409A taxes due to a failure by the employer to comply with the requirements for relief set forth in these instructions, will not be subject to penalties pursuant to R&TC § 19132 or R&TC § 19136 for the failure to timely pay § 409A taxes arising from the exercise of an applicable stock right in 2006, provided such § 409A taxes are paid with the filed return.

C. An Employer's Failure to Comply with Representations or Other Actions Required under the Program

Information and representations required under the California Program are material, and an employer who knowingly makes a false statement or representation will be deemed to have failed to make a further submission under the California Program so that no relief under the California Program is available to the employer or any employee. Except as provided in paragraph 5.B with respect to certain penalties, no relief is provided under the California Program with respect to an employer or to an employee if the employer fails to comply with the requirements of these instructions, provided that the FTB may, in its sole discretion, determine that the employer has substantially complied with the requirements of these instructions with respect to some or all of the employees identified by the employer and that, accordingly, such employer and some or all of such employees are entitled to the relief provided under FTB Notice 2007-1 and these instructions.

Section 6. Procedures for Submission of Notices and Further Submissions to the FTB

A. Submissions to the FTB

1. Correspondence Address and FAX Information

A notice of intent to participate in the California Program in accordance with section 4.A of these instructions, a second notice to the FTB in accordance with section 4.B.ii of these instructions, or a further submission in accordance with section 4.C of these instructions, shall be submitted to the following address(es):

By Mail:

Franchise Tax Board
C/O California 409A Compliance Program
PO Box 942867
Sacramento, CA 94267-1111

By Private Carrier or Overnight Delivery Service:

Franchise Tax Board
C/O California 409A Compliance Program
Sacramento, CA 95827

By FAX:

(916) 843-5407

2. California Program Payment Requirements

All payments must be made by check and submitted by mail, private carrier, or overnight delivery service. All checks must be payable to "Franchise Tax Board" and

contain a notation on the check indicating the payment is for "CA 409A Compliance Program."

Electronic Funds Transfer (EFT) is not an accepted payment method for participation in the California Program.

B. Requests for Further Information and Withdrawals of Applications and Further Submissions

The FTB reserves the right to request further information from an employer at any time following the employer's submission of a notice of intent to participate in the California Program. In addition, nothing in FTB Notice 2007-1, these instructions, or the California Program limits or otherwise affects the FTB's right to request further information, to examine a taxpayer's California tax return, and except as otherwise explicitly provided in FTB Notice 2007-1, these instructions, and the California Program, to assess any unpaid taxes, penalties or interest.

The employer retains the right to withdraw a notice of intent to participate or a further submission at any time on or before June 30, 2007, provided that notices are provided under section 4.D of these instructions that reflect the withdrawal. The employer also retains the right to modify a further submission at any time on or before June 30, 2007, provided that a modification after April 17, 2007, involving the payment of additional § 409A taxes is subject to the requirement of an additional amount due for further submissions after April 17, 2007, with respect to the additional § 409A taxes identified in the modification, and provided that notices are provided under section 4.D of these instructions that reflect the modification. Where an employer withdraws a submission on or before June 30, 2007, the employer is entitled to a return of the funds submitted to the FTB, without interest. Where an employer modifies a further submission in a manner that reduces the § 409A taxes covered by the further submission, the employer may obtain a return of amounts previously submitted to the FTB consistent with such modification, without interest, provided such modification is submitted on or before June 30, 2007. After June 30, 2007, an employer may obtain a return of any amount paid to the FTB with respect to an employee pursuant to these instructions if the employer demonstrates that the employee for whom the § 409A taxes were paid has paid the § 409A taxes in full.

For information about these instructions, call Jeanne M. Sibert at (916) 845-5554 or Deirdre O'Connor at (916) 845-7335 (not toll free numbers).